



The Real Estate Roundtable

Statement
of
Jeffrey D. DeBoer
before a Joint Hearing of the
Financial Services Committee's Subcommittee on Oversight and Investigations
and the Homeland Security Committee's
Subcommittee on Intelligence, Information Sharing
and Terrorism Risk Assessment
regarding
Terrorism Threats and the Insurance Market

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SUMMARY

Chairwoman Kelly, Chairman Simmons, Ranking Member Gutierrez, Ranking Member Lofgren, and Members of the Subcommittees, we commend you and the members of both of these Subcommittees for holding this joint hearing today. Individually, and collectively, you have been extremely focused following 9/11 in working to find solutions to the economic risks associated with terrorism.

From the policyholder perspective, obtaining adequate terrorism insurance is critical to developing, financing or transferring business property. The amount of needed terrorism insurance is typically dictated by lenders and rating agencies that have historically taken the position that "all risk" coverage includes terrorism insurance. This position has been supported by the courts and in effect, creates high demand for the product.

In our view, the risks to the economy posed by the inability of private insurance markets alone to provide adequate terrorism insurance capacity to our nation's businesses is a logical consequence of the nature of the risk itself. We view this inability of private markets alone to meet the needs of our economy as a major risk to our homeland security. Without adequate terrorism insurance capacity, economic transactions will be smothered and jobs will be at risk. Moreover, without adequate terrorism insurance capacity, the ability of the economy to quickly recover following a terrorist attack will be dramatically impeded and our nation's homeland security will be weakened.

The current public-private partnership known as TRIEA has been a worthy short-term solution; however, it is set to expire at the end of 2007 – in less than 17 months. We share the view that the threat of terrorism is not on the decline, and as a consequence the real estate industry has invested vast sums on various mitigation activities and undertaken an unprecedented multi-sector initiative to share information locally and nationally on terror related risks, vulnerabilities and mitigation strategies with government at all levels.

We look forward to working with Congress, and with the Members of these two Subcommittees in particular, to find a long-term solution to this long-term economic risk to homeland security. Among the potential solutions we urge Congress to review as it searches for a long-term solution is one modeled after the United Kingdom's Pool Re program. Such a program, modified to respond to the much more diverse and dynamic U.S. economy, is presented as an attachment to this statement.

BACKGROUND

I am President and CEO of The Real Estate Roundtable, an organization that represents the leadership of the nation's top 100 privately owned and publicly-held real estate ownership development, lending and management firms, as well as the elected leaders of the 15 major national real estate industry trade associations. Collectively, Roundtable members hold portfolios containing over 5 billion square feet of developed property valued at nearly \$700 billion, and participating Roundtable trade associations represent more than 1 million people involved in virtually every aspect of the real estate business.

I also serve on the Steering Committee of the Coalition to Insure Against Terrorism (CIAT) which is a broad coalition of 86 major trade and professional associations and businesses. CIAT represents the nation's major consumers of commercial insurance lines such as the United States Chamber of Commerce, the International Council of Shopping Centers, the National Association of Real Estate Investment Trusts, the National Rural Electric Cooperative Association, Major League Baseball, the NFL, the American Resort Development Association and related industries within the travel, tourism, and hospitality sector, to name a few.

I also serve as the co-Chair of the Advisory Board for RAND's Center for Terrorism Risk Management Policy, and as chairman of the Real Estate Industry Information Sharing and Analysis Center (RE-ISAC).

DISCUSSION

Underlying Facts Have Not Changed

As John Adams famously once said: "Facts are stubborn things; and whatever may be our wishes, our inclinations, or the dictates of our passions, they cannot alter the state of facts and evidence."

My message today is simple and straightforward.

The facts which prompted Congress and President Bush in 2002 to work daily to enact the Terrorism Risk Insurance Act (TRIA) unfortunately have not changed. The threat of terrorism continues to be an unpredictable, man-made threat as opposed to natural, somewhat predictable, property and casualty risk. Terrorism continues to be an act against our governmental policies and our “way of life”, it is not an attack on an individual business or property owner. Where terrorists might strike, and how they might attempt to do so, continues to be an evolving picture, based somewhat on the mitigation actions of property owners, but more frequently on the “hardening” of governmental targets.

Consequently, in our view, insurers and reinsurers logically continue to be unable to assess and price terrorism risk insurance. Until there is clear evidence that these facts have changed, and the overall risks to our society subside, we see a continuing need for federal involvement in the failed terrorism risk reinsurance market.

This federal governmental involvement may be either in the form of TRIA, TRIEA, or a pooling mechanism along the lines discussed later in this statement.

When terrorists attacked the U.S. on September 11, 2001, American businesses that carried property and casualty insurance, were insured against terrorism. Prior to 9/11, insurers provided terrorism coverage effectively free of charge because the perceived risk from terrorist acts was considered minimal.

After 9/11, the terrorism insurance marketplace dramatically changed.

Reinsurers concluded that they could no longer quantify the risk and effectively withdrew from the terrorism risk reinsurance market. This is important because of the roughly \$33 billion in 9/11 related claims paid, including commercial liability and group life, about two thirds of these losses were paid by reinsurers.

To our knowledge, this fact regarding reinsurers remains true today. The reinsurance industry estimates that only about \$6 to \$8 billion in terrorism capacity is currently available, with reinsurance capacity estimated at only \$1 to \$2 billion for nuclear, biological, chemical and radiological (NBCR) coverage. This is only a fraction of what is needed to provide adequate insurance to the U.S. economy.

With reinsurers out of the “post 9/11, pre-TRIA” market, primary insurers were not able to effectively manage their exposure to terrorism risk and they withdrew from the market where by law, they could.

This fact regarding primary insurers also remains true today. Without adequate reinsurance availability, primary insurers will not risk the exposure to their company associated with potential catastrophic terrorism losses.

Economic Risks are Great

As a result, prior to TRIA's enactment, the capacity for terrorism risk coverage quickly dropped, leaving America's businesses with few options. A survey The Real Estate Roundtable conducted during the 14 month post 9/11, pre TRIA time period showed that more than \$15 billion of real estate related transactions had been either stalled or completely canceled because of a lack of terrorism insurance. Statements attributed to the White House Council of Economic Advisors indicated that approximately 300,000 jobs were lost during this period.

The interwoven nature of America's economy, and evidence that terrorism is a threat to national economic activity, is demonstrated by these statistics as well as by the anecdotal reports that although the 9/11 attacks occurred in New York and Washington, within days, busboys in Seattle and hotel employees in Houston had lost their jobs.

Fortunately, in November 2002, Congress and the President joined together to enact the Terrorism Risk Insurance Act of 2002 (TRIA).

When President Bush signed TRIA, he described the legislation as being a vehicle to move construction projects forward, secure billions of dollars in investments, put citizens back to work, and give investors in markets "*greater confidence that our economy is strong enough to withstand a future attack.*" His assessment was correct.

Almost overnight, TRIA filled the reinsurance crater and provided capacity to insurance markets which in turn yielded the economic confidence for transactions to resume. In particular, stalled construction projects moved forward to the benefit of countless workers in the construction trades.

Terror Insurance Take-up Rate is High

The rapid market penetration following enactment of TRIA is almost unprecedented.

Today, the need and demand for terrorism insurance is *extraordinary*. The various studies of take-up rates (Wharton, MBA, Marsh, Aon) all show a higher percentage of commercial buyers – and not just those in presumed high-risk cities — purchasing terrorism cover than the take-up rate in almost any other field where the Federal (or State governments) have provided capacity, be it flood, crop or earthquake insurance, or under previous programs for riot and crime insurance. In fact, there has been a continuous increase in the so-called "take-up" rate for terrorism insurance. The take-up rate in the fourth quarter of 2004 was more than double the rate in the second quarter of 2003. And, the 2004 annual take-up rate of 49 percent was an 80 percent increase over the 2003 rate. Our information is that this trend has continued under TRIA.

Who's buying this coverage?

Financial institutions, real estate firms and health care facilities have the highest take-up rates. But right behind them are media companies, educational institutions, energy companies and transportation firms.

Having said that, Roundtable members tell us that the state of the insurance markets is increasingly difficult. The multiple catastrophic exposures (hurricane, flood, earthquake, on top of terrorism) plus the high retentions of TRIEA and its pending expiration have caused many insurers, concerned about “aggregation” risk, to leave certain markets.

We occasionally hear suggestions that a private terrorism insurance market would exist without federal involvement under the theory that the federal government is crowding out the private market. This seems highly questionable. There is evidence that private reinsurers want very little exposure to terrorism risk as our information indicates that the industry has not even met the capacity demand of direct insurers for their deductible and coinsurance layers under the current TRIEA program (amounts that appear quantifiable).

Rating Agencies and Lenders Require Coverage

Rating agencies and lenders play a big role in the economic implications of this issue. Insurers must keep their potential exposure to terrorism losses low or face lower ratings. Likewise, without adequate “all risk” coverage, including terrorism insurance coverage, commercial mortgage backed security (CMBS) borrowers face tough choices, the threat of default and potential bond downgrades. This is critical. The \$709 billion U.S. CMBS market is the second largest source of commercial and multifamily real estate credit in the U.S. and now comprises nearly 26 percent of the \$2.7 trillion U.S. commercial real estate debt market. In 2005 alone, CMBS provided more than \$160 billion in debt capital to the commercial real estate industry, providing 30 to 40 percent of the total annual debt financing to commercial real estate borrowers.

Allow me to quote from reports by two of the nationally recognized rating agencies, Moodys and Fitch Ratings.

Moodys: ... “We are unaware of any viable private market initiative that would take the place of TRIA.”

Fitch Ratings: “If TRIEA expires prior to the formulation of a long term terrorism insurance solution, there could be numerous repercussions for the commercial real estate market.”

Should the back-stop expire, insurers dependent on the back-stop are likely to withdraw from the market place, resulting in dramatic drop of capacity. Without adequate terrorism insurance coverage, CMBS borrowers face tough choices and the threat of default. As such, it would appear likely that Fitch’s concerns of disruption in the CMBS market are well founded. In fact, based on its overview of coverage in place and the ongoing loan requirements for coverage, Fitch has declined to rate certain transactions.

Lenders have a role in the marketplace as well. When commercial insurance carriers excluded terrorism insurance coverage prior to the enactment of TRIA, the risk of a catastrophic terrorism loss shifted from the commercial insurance industry to the commercial real estate industry. For this reason, borrowers, lenders and loan servicers who bear a responsibility, to investors and funding sources, have much at stake in maintaining broad availability and affordability of terrorism insurance. Commercial real estate faces material difficulties if a long-term terrorism insurance solution is not created before TRIEA expires. In fact, a study performed by the Mortgage Bankers Association revealed that 84 percent of the surveyed loans had terrorism insurance in place. This high percentage of properties with terrorism coverage in place countered the misconception that terrorism insurance was only for trophy properties located in high risk markets. Most currently available terrorism risk insurance policies are directly conditioned to the TRIEA “make available” provisions.

The Real Estate Roundtable and CIAT represent the consumers of this product called terrorism insurance. We listen to the manufacturers of this product, the reinsurance and insurance industry. We also listen to market analysts, such as Fitch and Moodys. And, we listen to the requirements of our lenders. Our conclusion is that without a federal terrorism program the economy will go “back-to-the-future” to the “post 9/11- pre TRIA” world when transactions were stalled or canceled and jobs were lost.

Today's Market is Tightening

Even now, with the clock winding down on the current program, America's businesses face the threat of going “bare” on terrorism coverage for our existing portfolios in just a few months.

Remember, unlike private market reinsurance treaties, TRIEA does not provide for a “runoff” period, where primary insurance policies continue after expiration of the reinsurance treaty.

This important point helps to demonstrate what will happen without a federal terrorism program. According to a Moody's report, 50 percent to 75 percent of all policies written prior to TRIEA's enactment adopted springing exclusions that would have automatically voided terrorism coverage beginning January 1, 2006, if TRIEA was not enacted.

Past is prologue.

Policyholders now in the market shopping for policies that run past 2007 year-end are being asked to once again accept “springing exclusions” in their insurance policies. These springing exclusions are strong evidence that without federal involvement, a sharp reduction in insurance availability will result.

The ultimate victims will be the American economy and jobs. The true targets of terrorism.

The adverse consequences of not having coverage available are, more than with almost any other line of insurance, immediate – that is, the effect on the economy would be immediate, not just after an uninsured loss.

In addition to the expected negative drag on economic activity, we would predict “forced placement” litigation if terrorism insurance capacity drops back to pre-TRIA levels. Loan documents have responded to the new terrorism insurance market by conditioning the requirement to procure terrorism insurance on “reasonable rates” and “commercially available” coverage. In recent years commercial mortgage loan servicers have made great efforts to understand terrorism risk and verify the purchasing of terrorism insurance associated with loan financing. Again, according to the national rating agency Fitch Ratings, should there be a sudden constriction in the terrorism insurance market, servicers and borrowers are likely to wind up in court battles over “reasonableness” of rates and availability. Under the current federal back-stop and make-available requirement, Fitch Ratings has observed that the courts have generally found terrorism insurance reasonably priced and available.

America’s industries, and many policymakers, are highly concerned with nuclear, biological, chemical and radiological (NBCR) exposures. It is important to note that even though TRIEA does cover these perils, we continue to see no evidence that such coverage is being written, except where mandated in workers compensation coverage. Unfortunately, even with TRIEA, the private markets have failed for this important coverage. Unlike other forms of terrorism insurance, NBCR coverage is not required to be “made available” to commercial property owners and therefore is not widely available.

However, I would point out that Wharton’s research last year indicated that there is more than \$30 billion of captive capacity for stand-alone terrorism coverage licensed in Vermont alone. Much of this amount provides NBCR coverage and represents capacity that depends on the continuation of the federal back-stop. Should the back-stop expire, this capacity will withdraw and our nation would have virtually no insurance coverage against NCBR attacks.

Capital Markets Offer Limited Assistance

We are also aware that catastrophe bonds (CAT bonds) are sometimes viewed as a potential private sector solution. We support efforts to further investigate this potential. But, unfortunately, to our knowledge no CAT bond has ever been financed solely for an ongoing terrorism risk to property. Such bonds have been used for discreet events of limited duration where massive security precautions have been involved – such as the Olympics or the World Cup – but not to provide the insurance protection needed by an ongoing commercial enterprise. In fact, many capital market experts do not consider the world cup soccer bond (FIFA) or the life insurance bond (VITA) to be true “terrorism” risk bonds. Although both include terrorism as a possible cause of loss, the FIFA bond is primarily an event cancellation bond (also requiring the event to be restaged elsewhere if possible), and the VITA bond was designed more for pandemics than terrorism attacks.

In short, there is no evidence to suggest that rating agencies or capital market investors will be better able to quantify the risk of terrorism than have insurers or reinsurers. Nor is it likely that CAT bonds or other risk transfer mechanisms alone will be able to offer the capacity necessary to insure America's businesses, workers and property owners against the risk of terrorism. The inability of CAT bonds to provide adequate terror insurance capacity is due again to the risk uncertainty associated with man-made terrorism, uncertain potential losses, and asymmetric threat and security information likely to be known only by terrorists and by government.

Mitigation Steps are Underway

Some inquire about steps policyholders have taken to mitigate against the risk of terrorism. In fact, in the real estate industry, vast sums have been spent on security personal, surveillance systems, barriers and all manner of additional protections. Future development and design protocol already call for increased setbacks and strengthened building cores. HVAC and air intake systems are now much more heavily secured. Importantly, terrorism risk mitigation strategy is now at the "Board" level of large scale property owners. In addition, steps have been taken to encourage tenants to implement emergency protocol and to coordinate them within buildings.

More specifically, managing the risk of terrorism in the post 9/11 environment has galvanized our industry's individual and common resources to an unprecedented degree. By our industry's standard benchmarking reference — BOMA's 2005 Experience Exchange Report¹ — we are spending, as an industry, over 20% more on security than we were pre 9/11. And yet, I hesitate to mention that statistic because in the end managing risk is not principally about allocating *additional* resources, it is about strategically using *existing* resources to cost-effectively mitigate risks. Information and experience are two assets that are hard to put a dollar value on and yet they may be the most critical resources we have. Post 9/11, there has been an unprecedented degree of information sharing within our industry and with local, state and federal counter-terrorism and emergency response authorities. This sharing of information — including best practices — is being advanced through various local associations and nationally by the Real Estate Information Sharing and Analysis Center or ISAC (www.reisac.org), and the various committees and task forces of national groups such as BOMA, ICSC, IREM, AHLA, NMHC, NAA, IFMA, and the Real Estate Roundtable. We are also allocating substantial resources as an industry to support the work of Rand Corporation's new Center for Terrorism Risk Management Policy. (<http://www.rand.org/multi/ctrmp>)

¹ The Experience Exchange Report is an annual income and expense benchmarking report for the commercial real estate industry performed by the Building Owners and Managers Association International for more information see www.boma.org. The report is based on the weighted average responses of 3,210 buildings, representing approximately 700 million square feet of space.

SOLUTION

Strong markets must have certainty. A long-term solution to the long term terrorism risk problem is essential.

One might ask: other countries have longer-term terrorism insurance solutions, why don't we? Much can be learned from nations such as Australia, Germany, Israel and the United Kingdom, nations that have recognized that private insurers alone cannot underwrite the risk of terror.

TRIA or TRIEA are good programs, and perhaps they can be extended long term. But they are not the only potential answer. For example, we support the authorization of a voluntary mutual reinsurance entity that would be capitalized by insurer premiums and would in turn offer reinsurance coverage for a broad range of terrorism risk. We have developed the framework for one such idea – we call it *Homeland Security Mutual*. This pool would create an incentive for the growth of private capital devoted to terrorism risk.

By creating a layer of private capital between primary insurers and the federal government, this entity would provide continuity to the marketplace so that policyholders could get the coverage they need while diminishing the role of the federal government – and taxpayers – in the terrorism risk insurance market. Under our proposal, the current federal “backstop” would, over time, be shifted away from primary insurers to this new mutual reinsurer. It would only become activated when terrorism insurance losses from a certified act or acts of terrorism exceeded a certain level. A copy of this plan is attached.

CONCLUSION

A functioning economy is a central aspect of sound homeland security. We believe, as many Members of these Committees believe, that protecting America against the economic impact of terrorism – both in the face of terrorist threats and in the aftermath of any future terrorist attack – must be part of an overall pro-active homeland security effort.

In our view, without some form of federal involvement, there will not be adequate private market capacity to insure the American economy against the risk of terrorism, nor will there be adequate insurance to enable the economy to quickly rebound from any future terrorist attack. The facts do not support a different conclusion.

American business, and the real estate industry, is highly competitive and we strongly support private, market-oriented solutions to problems. We want markets to operate freely. But sometimes they are unable to function appropriately. As Alan Greenspan has testified several times before Congress over the recent years, “. . . there is no evidence that a private terrorism insurance market has yet developed, or in fact ever can, develop.”

Ensuring that terrorism risk insurance remains available and affordable for policyholders on a long-term basis must be an aspect of overall homeland security efforts. Until a long-term solution emerges for increasing the insurance industry's capacity and willingness to insure terrorism losses, we remain skeptical about the nation's ability to address financial losses in the wake of a future act of terrorism.

The clock is ticking. Our economic security, and we would assert our homeland security, hangs in the balance.

Thank you for the opportunity to participate today.